b) Cost accounting and price cap regulation of access rates provide sufficient safeguards by eliminating any incentive to shift costs to local services or to raise access rates.

The *NPRM* fails to consider that the Commission already regulates Independent LECs' access services, in part precisely to promote competition in interexchange services. Independent LECs are classified as dominant carriers for exchange access services, and their access services are subject to full tariff regulation pursuant to Section 204 of the Act and Part 69 of the Commission's rules. Independent LECs are also subject to extensive price and cost accounting regulation.

All the access the GTOCs and most of the other large Independent LECs[51] provide for interstate interexchange services is subject to price cap regulation by the Commission.[52] The Commission has itself determined that price caps regulation, even with sharing, "substantially curtails the economic incentive to engage in cross-subsidization."[53] Moreover, without sharing, price cap regulation effectively eliminates

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[51] SNET, Lincoln, Sprint Local, Frontier and Citizens are price cap Independent LECs. Some Independent LECs (*e.g.*, Cincinnati Bell) operate under a form of incentive regulation that is similar to price cap regulation while the rest are still regulated under rate of return regulation.

[52] Even at the state level, the GTOCs operate under price cap regulation in Alabama, California, Florida, Iowa, Michigan, Texas, Wisconsin and under other forms of incentive regulation in Virginia and Nebraska. These states account for 57 percent of the GTOCs' total access lines.

[53] *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873, 2924 (1989).

any incentive for cost shifting.[54] GTOC tariff entities representing approximately 50 percent of the rate base selected the no sharing option for the 1996 annual filing.[55] In addition, the Commission's price cap policy, through the Part 69 rules, requires LECs to account separately for interexchange costs and allocate them to a separate price cap basket.[56]

As for cost shifting, the GTOCs, like all Tier 1 LECs, are subject to accounting safeguards that require costs to be allocated based on a uniform accounting system and cost allocation principles. The LECs' accounting books are reviewed annually by independent auditors whose results are then reviewed by the Commission's auditors. Price cap LECs also are required to provide ARMIS reports that the Commission can use to track accounts over time or to compare LECs. These safeguards operate effectively to prevent cross-subsidy.

c) Non-price discrimination is neither practical nor deterred by dominant carrier regulations.

The notion that Independent LECs would have either the incentive or the ability to engage in quality degradation or similar activities is "inconsistent with regulation,

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[54] *See Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, CC Docket No. 94-1, 10 FCC Rcd 8961, 9045 (1995).

[55] GTE is optimistic that the Commission will realize the detrimental effect of sharing and eliminate this mechanism altogether in the price cap plan for local exchange carriers much as it did for AT&T and the cable industry.

[56] Furthermore, federal law prohibits Independent LECs from discriminating in price for access services. Any such price discrimination would become obvious to the Commission and rival IXCs through tariff regulation or cost accounting processes.

market developments and technological change that have occurred in the last decade in the telecommunications industry."[57] Moreover, the remedy of dominant regulation would not deter potential discrimination. Therefore, the Commission should disregard suggestions that Independent LECs could "leverage" non-price discrimination in access services into market power in interexchange services.

As for non-price discrimination, an Independent LEC has no practical ability to degrade the service provided particular IXCs over its network transmission facilities, most notably the common trunking facilities used by all IXCs (including its own). Nor can Independent LECs discriminate through selective service degradation of switching services. All lines are presubscribed and requests for service are treated in the same manner. Any systematic efforts to delay or misroute calls at the switch would be noticed immediately by the IXCs or their customers and obvious from trunk group reports routinely provided to IXCs on a monthly basis. In addition, the GTOCs file annual ARMIS service quality reports. These reports provide a ready means for IXCs to monitor service quality, and allow detection of any systematic discrimination.

Assuming an Independent LEC could discriminate, it could not capitalize on selective service degradation unless it were to advertise that its service was superior because it was free of such problems. To advertise the matter, however, is to disclose it.[58] As Professor MacAvoy states: "How can GTE operating companies reduce the

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[57] Spulber Statement at 41.

[58] Quite ironically, given the tenor of the *Notice*, it is *AT&T* that is advertising that *its* interexchange service is superior to that of GTE Long Distance, not *vice versa.*

quality of rivals' interexchange services in a way simultaneously observable to consumers but not to rivals and regulators?"[59] Once made known, regulators have ample authority to prevent the discrimination from recurring.

II. THERE IS NO LEGAL, FACTUAL, OR POLICY BASIS FOR IMPOSING A SEPARATE AFFILIATE REQUIREMENT ON INDEPENDENT LECS FOR THE PROVISION OF INTERSTATE, INTEREXCHANGE AND INTERNATIONAL SERVICES (¶¶158-159).

In Section I, GTE has demonstrated that the Independent LECs are non-dominant in the provision of interstate, interexchange services, regardless of the corporate structure through which they provide such services. This alone justifies elimination of the separate affiliate requirement.

However, in Paragraph 158, the *NPRM* solicits comment on a suggestion that, *regardless of whether Independent LECs are found non-dominant in the provision of interexchange services*, "some level of separation may be necessary between an Independent LEC's interstate, domestic, interexchange operations and its local exchange operations."[60] The *Notice* suggests that such separation could "minimize the potential that an independent LEC could use its control of local bottleneck facilities to

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See GTE Card Services Incorporated d/b/a GTE Long Distance et al. v. AT&T Corporation, Civ. Act. No. 3-96-CV-1970-D (N.D. Tex. filed July 15, 1996).

59 MacAvoy Statement at 13.

60 *Compare* ¶157 (soliciting comment on whether Independent LECs would have market power in interexchange services if the *Competitive Carrier* restrictions were lifted) *with* ¶158 ("some level of separation may be necessary between an Independent LEC's interstate, domestic, interexchange operations and its local exchange operations").

improperly shift costs or discriminate against interexchange competitors," asserting that such conduct would be of concern even if it did not provide a basis for classification as dominant.

Contrary to the suggestion of Paragraph 158, GTE respectfully submits that there is no basis for requiring Independent LECs found to be non-dominant in interexchange services to establish any level of separation between their interexchange and other services. Such action would (1) run wholly contrary to the deregulatory trend of the 1996 Act (including the specific elimination of a separate subsidiary requirement for the GTOCs), (2) ignore factual differences between Independent LECs and the BOCs, (3) lack any clear economic justification, (4) display a surprising lack of faith in safeguards that have worked successfully for years, and (5) ignore the substantial costs of separation to both Independent LECs and consumers.

Accordingly, the Commission should adopt the policy proposed in Paragraph 157, and eliminate the *Competitive Carrier* burdens that impair the ability of Independent LECs to offer much-needed competition in interexchange services.

A. The 1996 Act Reflects Congress' Determination That The Public Interest Does Not Require That The GTOCs Provide Interstate, Interexchange Services Through A Separate Affiliate.

First, in Section 601 of the Telecommunications Act of 1996, Congress specifically superseded both the *GTE Consent Decree* and the *AT&T Consent Decree*.[61] The *GTE Consent Decree* had prohibited the GTOCs from providing

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[61] The 1996 Act, Section 601(a)(2).

interexchange telecommunications services directly, but had allowed GTE or an affiliate of GTE not owned or controlled by a GTOC to provide such services.

The legislative history confirms that Congress did not intend GTE to be subject to separate affiliate requirements. As Senator Pressler noted in the Senate debate, "GTE is the only non-Bell telephone company with such cumbersome proceedings. These procedures resulted in higher costs and hamper GTE's ability to compete."[62] Twice in the Conference Report, the Committee indicates that GTE should not be bound by the interexchange restrictions. The most pertinent discussion occurs in the Conference Committee's discussion of Section 601:

> By eliminating the prospective effect of the GTE Consent Decree, this language removes entirely the GTE Consent Decree's prohibition on GTE's and the GTE Operating Companies' entry into the interexchange market. *No provision in the Communications Act should be construed as creating or continuing in any way the GTE Consent Decree's prohibition on GTE or its operating companies' entry into the interexchange market.*[63]

Congress surely did not intend to remove separation requirements applicable to the GTOCs by terminating the *GTE Consent Decree* only to have the Commission reinstate

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62 141 Cong. Rec. S8076 (daily ed. June 9, 1995) (statement of Senator Pressler).

63 H.R. Conf. Rep. No. 458, 104th Cong., 2d Sess. 199 (1996) (emphasis added). Similarly, in its discussion of Section 251, the Report states that:

> The use of the provisions of the respective consent decrees to provide, on an interim basis, the substance of the new statutory duty in no way revives the consent decrees. In particular, the use of the provisions of the GTE consent decree relating to equal access and nondiscrimination on this interim basis should not be construed in any way as recreating or continuing the GTE Consent Decree's prohibition on GTE's or the GTE Operating Companies' entry into the interexchange market.

H.R. Conf. Rep. No. 458, 104th Cong., 2d Sess.123 (1996).

them on the basis of the same facts Congress had before it when it passed the 1996 Act.

Second, the new interexchange provisions contained in Sections 271 (which governs BOC interLATA entry) and 272 (which imposes a separate affiliate requirement on the BOCs) by their language apply only to "Bell Operating Companies." Thus, Congress determined that there is no need to extend the separation requirements of Section 272 to Independent LECs generally or the GTOCs specifically. The Commission has recently acknowledged that Congress treated the BOCs and GTE differently with respect to in-region interexchange services.[64]

The omission of GTE and other Independent LECs was not accidental. When Congress intended for sections of the Act to apply to GTE and other local exchange carriers, it stated so unambiguously, such as in Section 251. Coupled with the fact that the Conference Report's discussion of Section 272 makes no mention of GTE or other Independent LECs, there can be no doubt that Congress did not intend to apply a separate affiliate requirement on Independent LECs, including the GTOCs. Given that Congress has found separation requirements unnecessary for the GTOCs, the FCC should not place such burdens on non-BOCs, and especially not the GTOCs.

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[64] *Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services*, Notice of Proposed Rulemaking, Order On Remand, and Waiver Order, WT Docket No. 96-162, FCC 96-319 at ¶88 (released Aug. 13, 1996).

B. There Is No Factual Basis For Imposing A Separate Affiliate Requirement On Independent LECs.

Not only is there no legal basis – in contrast to Section 272 – for a separate affiliate requirement on Independent LECs (particularly as to the GTOCs), there also are no factual grounds for imposing "some level of separation" on an Independent LEC providing interstate, interexchange services. The Congress, Judge Greene (who had jurisdiction over both the AT&T and GTE Consent Decrees)[65] and the Justice Department have concluded that there are material distinctions between Independent LECs and the BOCs. These distinctions arise from the geographical characteristics of Independent LEC local exchanges – their smaller size; their dispersion throughout the nation, rather than in regional concentrations; and the predominance of suburban and rural, rather than metropolitan, service areas. The different terminating patterns of GTOC- and BOC-originated interexchange traffic confirms these distinctions.

In any event, the speculations in the *NPRM* regarding how a LEC *might* engage in discriminatory conduct are simply that. There is no credible evidence in either the *NPRM* or the years that GTE owned Sprint or has operated GTE Long Distance that the GTOCs have ever shifted costs or engaged in discriminatory conduct against IXCs.

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65 *See, e.g., United States v. GTE Corporation*, 603 F. Supp. 730, 736-737(D.D.C. 1984) (noting that GTOC operations are widely scattered, while the BOCs are concentrated; GTOCs, unlike BOCs, control few inter-city facilities; GTOCs control relatively fewer access lines); *United States v. GTE Corporation*, C.A. No. 83-1298 (D.D.C. Mar. 26, 1992) (granting GTOC authority to use Signaling System 7 technology crossing LATA boundaries; U S WEST was denied same authority); *see also* Transcript of Oral Argument at 44, *United States v. GTE Corporation* (D.D.C. Nov. 22, 1983) (C.A. No. 83-1298) (Department of Justice attorney stating: "GTE is significantly a different company.").

1. Independent LEC operating areas are significantly different than BOC operating areas.

As the *NPRM* aptly observes,[66] Independent LECs typically are much less geographically concentrated than the BOCs, typically serve less densely populated areas, and offer fewer access lines in any state than do the BOCs.[67] All of these facts describe the GTOCs, but the one in particular that stands out is the geographic dispersion of the GTOCs' operating areas. The GTOCs operate in 28 states (two of which are Hawaii and Alaska) and in the CNMI – a more dispersed operating area than any other Independent LEC. In addition, Independent LECs generally do not have necessary facilities in-place or even readily available out of their service regions that could be used to exercise market power either in-region or out-of-region for interstate, interexchange calling. These substantial factual differences strongly counsel against any presumption that separation "safeguards" found appropriate for the BOCs by either Congress or the Commission are appropriate as well for Independent LECs.

a) Independent LECs have fewer access lines than BOCs on a state-by-state basis

With rare exceptions, Independent LECs serve far fewer access lines in a state than the BOCs. This is certainly true in the case of the GTOCs. Although the GTOCs provide local exchange services in 28 states and one insular point, in only one of these

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[66] *NPRM* at ¶147 (stating that the BOCs' local exchange and exchange access facilities "extend over much larger geographic areas than the Independent LECs' facilities").

[67] The exceptions are offshore points, such as Hawaii which is served only by GTE Hawaiian Tel and the CNMI which is served by MTC.

states (Hawaii) and in the insular point (the CNMI) is a GTOC the largest local exchange carrier. In virtually every other state, the GTOC is substantially smaller than the largest LEC in that state.

For example, in each of the three states – California, Florida, and Texas – in which the GTOCs have the most lines, the GTOC is far from being the largest local exchange provider. In California, the ratio of BOC to GTOC access lines is 3.6:1, in Florida, 2.5:1, and in Texas, 4.3:1.[68] In some states, the GTOC is not even the second largest local exchange provider. The GTOCs rank third among LECs in Nebraska, North Carolina, and Ohio, measured by access lines.

b) Independent LECs serve dispersed, less densely populated areas.

Independent LECs typically serve dispersed, less densely populated areas of the nation. For example, unlike the BOCs, the GTOCs are not confined to one particular region of the nation, but rather are scattered throughout 28 states spreading from Pennsylvania to Hawaii and Alaska to Florida.[69] The most states any Regional BOC serves is 14. While no Regional BOC serves more than 33 LATAs, GTOCs operate in portions of 123 LATAs.

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68 *TELEPHONE LINES AND OFFICES Converted To Equal Access*, Industry Analysis Division, Common Carrier Bureau, Table 5 at 12-13, 34-35 (June 1996).

69 *See TELEPHONE LINES AND OFFICES Converted To Equal Access,* Table 5 at 22-23 (separate data for Contel/dba/GTE and GTE North for Minnesota) and at 36 (separate data for Contel /dba/GTE and GTE South for Virginia). The GTE/Contel merger actually *decreased* the GTOCs' density per mile.

Even within those 28 states, the GTOCs' local telephone operations are often scattered over many non-contiguous, and less densely populated, areas. For example, in states where both the GTOCs and the BOCs operate, the BOCs have 76 percent of the access lines while serving only 34 percent of the land area; in contrast, the GTOCs have 13 percent of the access lines in those states but serve 17 percent of the land area. The fact that the GTOCs' serve only a small percentage of the population within the nation's largest Metropolitan Statistical Areas ("MSAs") confirms this point. The GTOCs have a majority presence in only two of the top 50 MSAs in the United States. A GTOC is the sole exchange carrier in only seven of the 320 MSAs, accounting for less than one percent of the U.S. population. GTOCs serve a majority of customers in only another 19 MSAs, which collectively have less than three percent of the U.S. population.

This dispersion has several consequences. First, the GTOCs' geographical separation makes an internal network between them uneconomical. Consequently, the GTOCs have no significant "official network" facilities for internal purposes that can readily be used to provide interexchange services. The interexchange components of GTE's internal communications travel almost exclusively on the facilities of unaffiliated IXCs. Thus, there are few facilities in place that could serve as an immediate springboard for interstate, facilities-based service. GTE believes that smaller Independent LECs likewise have few or no existing interstate facilities. Second, these statistics suggest that, compared to the BOCs, the GTOCs' local operations in any particular state tend typically to serve less densely populated rural and suburban areas, rather than major metropolitan population centers. Not surprisingly, business lines comprise a relatively smaller percentage of the GTOCs' access lines than of the BOCs.

c) Traffic patterns reflect the differences between GTOC and BOC exchanges.

The wide dispersion in the GTOCs' local exchanges also is reflected in the traffic patterns between those exchanges. For both interstate and intrastate calling, the vast majority of interexchange calls originating in GTOC local exchanges terminate in non-GTE exchanges. Overall, only 10 percent of all GTOC customers' interstate, interexchange calls both originate *and* terminate in GTOC exchanges. For example, the following chart shows interstate originating *and* terminating percentages of the three largest GTOC operating areas:[70]

INTERSTATE CALLS ORIGINATING IN A GTOC EXCHANGE AND TERMINATING IN A GTOC EXCHANGE		
California	Florida	Texas
10.7%	9.4%	14.4%

Even for intrastate, interLATA calls, the overwhelming percentage of calls originating in a GTOC exchange do not terminate in a GTOC exchange, as the following chart of the same three GTOCs clearly shows:[71]

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70 *See MacAvoy Statement* at 26.

71 *See MacAvoy Statement* at 28. These numbers will differ drastically depending on (1) the number of LATAs in a state and (2) the number of LATAs in which a

INTRASTATE INTERLATA CALLS ORIGINATING IN A GTOC EXCHANGE AND TERMINATING IN A GTOC EXCHANGE		
California	Florida	Texas
20.5%	1.1%	19.6%

In contrast, the percentage of interLATA traffic (interstate and intrastate) for which the Regional BOCs ("RBOCs") provide access services that both originate and terminate in a single RBOC's region is far larger:[72]

INTERLATA CALLS ORIGINATING IN AN RBOC EXCHANGE AND TERMINATING IN THE SAME RBOC'S EXCHANGE		
Pacific Telesis	BellSouth	Southwestern Bell
50%	51%	45%

The greater proportion of intra-region calls carried by the RBOCs relative to the GTOCs is attributable to the RBOCs' greater contiguity and size.

These calling patterns demonstrate that the GTOCs have less ability than the RBOCs to affect the costs of IXCs. In addition, these calling patterns affect the

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GTOC has exchanges. *See also* discussion *supra* on the population characteristics of GTOC serving areas.

72 These numbers are for AT&T carried calls only. *See* Affidavit of Douglas Bernheim and Robert D. Willig on behalf of AT&T, Table 1 at 19, United States of America v. Western Electric Co., Inc. (Civil Action No. 82-0192 D.D.C.) (filed Dec. 6, 1994).

incentive that the GTOCs might have to build an interexchange network linking their exchanges. The wide dispersion of the GTOCs' exchanges, the comparatively little traffic among such exchanges, and the lower overall traffic originating in their exchanges reduce their incentives to build such a network. Thus, while the GTOCs possess some in-region facilities typically used for intraLATA toll, GTE does not have interLATA facilities in place and, therefore, currently is entering the interLATA market as a reseller, a fact which further reduces the likelihood that its interexchange services could in fact be dominant.

2. Paragraph 158's concern that Independent LECs could harm competition even if classified as non-dominant in interexchange services is flawed as a matter of both law and economics.

Paragraph 158 of the *NPRM* speculates that Independent LECs could "leverage" their access facilities to harm competing IXCs, even if the Independent LECs are themselves found non-dominant in interexchange services. This theory is questionable both as a matter of law and as a matter of economics, and amounts to protection of particular *competitors*, not *competition*. Thus, it should provide no independent basis for imposing a separate affiliate requirement.

As a matter of law, Independent LECs cannot damage competition unless they can exercise market power. As the D.C. Circuit has plainly stated, "[w]hatever it means to 'leverage' one's monopoly power, the DOJ is surely correct that no damage to competition – through 'leverage' or otherwise – can occur unless the [LECs] can exercise market power." *United States v. Western Electric Co.*, 900 F.2d 283, 296 (D.C. Cir. 1990). If the Commission has concluded that an Independent LEC could not raise prices in the interexchange market, then it follows that there can be no damage to *competition.*

Furthermore, the "leveraging" theory is unsound as a matter of economics. As Professor MacAvoy explains:

> an attempt to leverage from a bottleneck in local exchange to a second monopoly in long-distance service would not increase profits because the two services are used in fixed proportions--a minute of (bottleneck) local access is necessary to originate a minute of interLATA transport and exchange service.[73]

For this reason, the gain in price in the "second" monopoly would equal the loss in price from the access "monopoly," and thus it can be seen that no "second" monopoly actually exists.[74] Furthermore, extensive regulatory oversight prohibits any price or service discrimination in access services.[75]

3. The "cost-shifting" and discrimination rationales cited by Paragraph 158 of the *Notice* provide no justification for a separate affiliate, as other regulations already address cost allocations directly and comprehensively.

As shown above, the risks of cost shifting and discrimination – the only rationales mentioned in Paragraph 158 – are already thoroughly addressed by the Commission's current arsenal of regulations. These include extensive cost accounting safeguards to prevent cost shifting, caps on prices of access services to eliminate any *incentive* to

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73 MacAvoy Statement at 9.

74 *Id.* at 10.

75 *Id.* at 10-11.

shift costs, and extensive regulations to prevent non-price discrimination in the quality of access services provided.

The *Notice* utterly fails to identify any purported deficiency in existing federal and state rules and regulations that would justify retention of any separation requirement on Independent LECs. Nor does the *Notice,* despite Independent LECs having provided interexchange services for many years, identify any instances of abuses, cost misallocations, or other discrimination. Given the vast changes now transforming telecommunications, the Commission should not lightly retain burdensome regulations – such as a separate affiliate requirement – without a clear, demonstrable showing of need. This is especially the case where, as here, such a requirement in fact imposes *additional* burdens on Independent LECs and constitutes nothing more than regulatory protectionism of incumbent IXCs.

C. The Real Costs Of Requiring Any Level Of Separation For Independent LECs Greatly Outweigh The Speculative Benefits.

Before imposing a separation requirement of any type on non-dominant Independent LEC interexchange services, the Commission also must weigh the costs and benefits of any such policy. GTE submits that the costs of such a separation, both to the Independent LEC and to the public, would greatly outweigh any plausible benefit.

1. Greater regulation of Independent LECs than incumbent IXCs would reduce competition.

A separate affiliate requirement on the provision of domestic, interstate, interexchange services by Independent LECs would harm rather than promote competition. A separation requirement would unnecessarily increase the costs of the

Independent LECs' interexchange offerings, thereby constraining their ability to compete on the basis of price with the large, well-established firms that currently dominate the market.

It is indisputable that a separate affiliate requirement would raise an Independent LEC's costs.[76] The administrative costs of a separate affiliate alone would eliminate beneficial operational efficiencies. The prohibition against efficient sharing of facilities also unnecessarily raises costs.[77] These regulatory costs could be large where, as here, the evidence strongly suggests that there are economies of integration.[78]

In this context, it is noteworthy that although AT&T has filed for local certification in all fifty states, there currently is no federal requirement that it separate its local and interexchange services, or even that it assess access charges for its local services. Nor is there any requirement that MCI offer interexchange and local services through separate affiliates. Further, the recent announcement of the acquisition of MFS by LDDS WorldCom produces a merger of two companies[79] – a large CLEC and the fourth largest IXC – that has the option of operating either as a vertically integrated company or as affiliates and will be classed as non-dominant under either option. If three out of

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[76] The FCC has long recognized that structural separation imposes costs on the regulated entities. *See, e.g., Third Computer Inquiry,* 104 F.C.C.2d 958, 964 (1986) (subsequent history omitted).

[77] *See* Spulber Statement at 53.

[78] MacAvoy Statement at 11.

[79] *See The Wall Street Journal*, "WorldCom Deal Gives 'Local Access' A Buzz," Aug. 27, 1996 at C1.

the four largest incumbent IXCs – which plainly dominate the interexchange market even if not classified as "dominant" under the FCC's rules – are allowed to provide local and interexchange services on a vertically integrated basis, it is clear that newly entering Independent LECs operating through a separate subsidiary would be at a significant cost disadvantage.

Simple fairness dictates that new entrants in the market should have the same freedom to offer services in a flexible manner. As Professor Spulber states: "If rules are not applied fairly and evenly, the result is not deregulation but managed competition."[80] This outcome, while comfortable for competitors, is injurious to consumers.

2. Different regulation of in-region and out-of-region services would reduce competition.

The Commission should regulate an Independent LEC's in-region and out-of-region interexchange services in a consistent manner. In CC Docket No. 96-61, the Commission proposed to modify or eliminate the separate affiliate requirement imposed on Independent LECs as a condition for non-dominant treatment as an interstate, interexchange carrier when operating outside its local exchange areas.[81] Assuming that

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80 Spulber Statement at 50.

81 *Policy and Rules Concerning the Interstate, Interexchange Marketplace: Implementation of Section 254(g) of the Communications Act of 1934*, Notice of Proposed Rulemaking, CC Docket No. 96-61, FCC 96-123 at ¶61 (released Mar. 25, 1996).

the Commission adopts that proposal,[82] it should apply the same regulatory regime to in-region services as well.

Differing regulatory classifications and structural requirements for in-region and out-of-region services would be especially difficult for Independent LECs in light of their dispersion. The *NPRM* proposes to define "in-region" for an Independent LEC as, generally, its local exchange area.[83] GTE supports this definition. As a consequence, however, Independent LECs, such as the GTOCs, will offer both "in-region" and "out-of-region" interexchange services within a single state. A regulation that would carve GTOC interexchange services into geographic submarkets, defined by the location of its local exchanges – "out-of-region" integrated GTOCs and "in-region" separate affiliates – produces an irrational result.

Such a regulation would obviously, and pointlessly, impose substantial costs. These costs would directly translate into higher costs of providing service to customers, and constrain GTE's price competitiveness. Further, it is no answer to suggest that the GTOCs, for reasons of operational efficiency, could choose to provide service only through a separate affiliate both in- and out-of-region. Such a result would add to the GTOCs' cost of doing business everywhere and would be contrary to Congress' intent in rescinding the GTE separate affiliate requirement.

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82 GTE filed Comments strongly supporting the Commission's proposal in that docket. *See* Comments of GTE, CC Docket No. 96-61 (filed April 19, 1996).

83 *NPRM* at n.12.

III. A GTOC's INTERNATIONAL SERVICES SHOULD BE CLASSIFIED IN THE SAME MANNER AS ITS DOMESTIC, INTERSTATE, INTEREXCHANGE SERVICES (¶¶160-161).

The provision of international services by a GTOC should be regulated in the same manner as the provision of domestic interexchange services. International services raise no different issues than domestic interexchange services. In both cases, the services require use of the LEC's local network to access the IXC; only the transmission facilities used to provide the international portion of the services is different.

For the same reasons shown with regard to domestic, interstate, interexchange service, Independent LECs have no market power in the international market. Since Congress has determined that a GTOC's provision of interexchange service does not require structural separation, international services should be treated similarly.[84]

As proposed in the *NPRM*, however, GTOCs, like other carriers, would be subject to dominant classification on particular routes pursuant to the *Foreign Carrier Entry Order,* which conditions dominant status on certain affiliations with foreign carriers. This will ensure that GTOCs can compete in the international services market with other carriers on a level playing field but will not have an advantage on those routes in which they are affiliated with a foreign carrier.

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[84] It should be noted that the Commission found AT&T non-dominant despite a share of the international market greater than 74 percent. *See AT&T International Order* at ¶40.

CONCLUSION

For the foregoing reasons, GTE Service Corporation, on behalf of its affiliated local exchange and interexchange operations, respectfully urges the Commission to eliminate the separate affiliate requirement for GTOC provision of interexchange services, and to classify such service offerings by GTOCs as non-dominant for purposes of Title II regulation.

Respectfully submitted,

GTE Service Corporation and its affiliated domestic telephone and interexchange companies

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August 29, 1996

THEIR ATTORNEY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

IN THE MATTER OF	)	
	)	
IMPLEMENTATION OF THE NON-ACCOUNTING SAFEGUARDS OF SECTIONS 271 AND 272 OF THE COMMUNICATIONS ACT OF 1934 AS AMENDED;	)	CC DOCKET NO. 96-149
	)	
AND	)	
	)	
REGULATORY TREATMENT OF LEC PROVISION OF INTEREXCHANGE SERVICES ORIGINATING IN THE LEC'S LOCAL EXCHANGE AREA	)	

STATEMENT OF PAUL W. MACAVOY
ON BEHALF OF
GTE SERVICE CORPORATION

My name is Paul W. MacAvoy and I hold the Williams Brothers Professorship at the Yale School of Management. Formerly I was Dean of the Yale School and Dean as well as John M. Olin Professor at the University of Rochester's William E. Simon Graduate School of Business Administration. I have authored numerous journal articles and seventeen books on regulation and corporate strategy in the network industries, including most recently THE FAILURE OF ANTITRUST AND REGULATION TO ESTABLISH COMPETITION IN LONG-DISTANCE TELEPHONE SERVICES (AEI Press and MIT Press, 1996).

I have been asked by GTE Service Corporation ("GTE") to analyze certain proposals considered in this Notice of Proposed Rulemaking ("Notice"),[1] in particular

[1] FCC, Notice of Proposed Rulemaking, CC Docket No. 96-149 (released July 18, 1996) (hereinafter "Notice").

whether independent local exchange carriers such as the GTE Telephone Operating Companies should be classified as "dominant" or "non-dominant" in the provision of in-region, interstate, long-distance services. The Notice specifically requests comments on the following topics:

- Definition of the relevant market;[2]
- The prospects for local exchange carriers discriminating in their provision of services to rival interexchange carriers so as to increase rivals' costs;[3] and
- Whether local exchange carriers can gain an unfair competitive advantage over interexchange rivals by predatorily pricing in long-distance markets while misallocating reported costs associated with that pricing to "bottleneck" local exchange service categories.[4]

Section I of this statement responds to the Notice's request for comments on these three issues. Section II analyzes the Federal Communications Commission's ("Commission's") standards for determining what constitutes a "dominant" carrier. It is my position that the criteria in the Commission's recent non-dominance decision regarding AT&T should be consistently applied to independent local exchange carriers. Therefore, in this section the Commission's criteria for finding dominance are reviewed and applied to the GTE local operating companies. Section III provides my conclusions from application of these standards to the GTE operating companies.

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[2] Notice at ¶¶ 115 to 129.

[3] Notice at ¶¶ 134, 157.

[4] Notice at ¶¶ 135, 158.

I. BOTTLENECK LOCAL SERVICES AND HYPOTHETICAL DOMINANCE IN LONG-DISTANCE SERVICES

The Notice raises two arguments regarding the ability of independent local exchange carriers to use their bottleneck facilities to establish positions of dominance in the provision of long-distance services. First, it suggests that by pricing in a predatory way and then improperly allocating costs of predation to regulated local exchange services, a local exchange carrier gains an unfair advantage over its interexchange rivals. The Notice's concern is that an independent local exchange company could carry out a predatory price campaign for interexchange services with ensuing losses from below-cost pricing financed by increases in costs allocated for rate-making purposes to local exchange service. The Notice expresses concern that this strategy may enable an independent local exchange carrier "to set retail interLATA prices at predatory levels (i.e., below the costs incurred to provide those services), drive out its interLATA competitors, and then raise and sustain retail interLATA prices significantly above competitive levels."[5]

Second, local exchange carriers can leverage bottleneck facilities in local exchange to achieve dominance in interexchange services.[6] As the Notice states, an independent local exchange carrier "could provide its affiliate's interLATA competitors with poorer quality interconnection to [its] network than it provides to its affiliate. . . . To the extent that interexchange customers believe that the affiliate offers a higher quality of service, the [independent local exchange carrier] may be able to raise its interLATA prices."[7] Although leveraging arguments have an extended and controversial history in antitrust

[5] Notice at ¶ 135.

[6] Notice at ¶ 139.

[7] Notice at ¶ 139.

economics,[8] here the Commission has developed the argument to make it uniquely obvious. Not only can a firm leverage its alleged market power in one market to enter another successfully, but also it attains control of that market with such certainty that regulation as a dominant carrier should apply *ex ante*.

Both predation and leveraging involve consideration of traditional, horizontal market power determinants. These determinants were used by the Commission in its October 1995 Order, which found that AT&T was no longer a dominant carrier.[9] They include market share, supply and demand elasticities, and the conduct of firms in establishing prices and sales levels. But as a threshold matter, in order for an independent local exchange carrier to carry out a monopolizing strategy in interexchange services based on its ownership of bottleneck facilities it must predictably be able to show the following results, which follow logically from the Commission's recent non-dominance decision:

- either have or demonstrate the potential to acquire greater than a 55 percent market share at the level allowing control of market prices;
- set higher prices in the long-run than those of the established interexchange carriers (possibly after a period of charging predatorily low prices);
- maintain a market position that cannot successfully be reduced by rivals in the future.

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[8] *See, e.g.*, Bowman, W. (1957), *Tying Arrangements and the Leverage Problem*, YALE LAW REVIEW, vol. 67, pp. 19-36; Burstein, M. (1960), (1960), *The Economics of Tie-In Sales*, REVIEW OF ECONOMICS AND STATISTICS, vol. 42, pp. 68-73; Blair, R. and Kaserman, D. (1978), *Vertical Integration, Tying, and Antitrust Policy,* AMERICAN ECONOMIC REVIEW, vol. 68, pp. 397-402.

[9] FCC, In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, CC Docket 95-427 (released October 23, 1995) (hereinafter "AT&T Non-Dominance Order").